Committee on Resources

Testimony

Subcommittee on Water and Power
Thursday, June 12, 1997
1324 Longworth HOB, 2:00 P.M.

Testimony of Steve Waddington
Executive Director, Direct Service Industries, Inc.
Before the
U.S. House Subcommittee on Water and Power Resources

June 12, 1997

Mr. Chairman and members of the subcommittee, thank you for inviting me to testify before you on the important matter of the future role of the Bonneville Power Administration (BPA). My name is Steve Waddington. I am the executive director of Direct Service Industries, Inc. (DSIs), a trade association of industrial customers that purchase electric power directly from the BPA, as well as from other bulk power suppliers in the competitive marketplace in the Pacific Northwest. Members of DSI, Inc. are six aluminum companies in Washington and Oregon, specifically: Alumax, Inc., Goldendale Aluminum Company, Kaiser Aluminum & Chemical Corporation, Northwest Aluminum Company, Reynolds Metals Company, and Vanalco, Inc.

Although one aluminum company was represented on the Steering Committee of the Comprehensive Regional Review of the Northwest Energy System, the DSIs were not represented as a group. The DSIs followed the year-long deliberations of the Steering Committee closely, and we are now participating in the current efforts in multiple forums to implement the recommendations of the Regional Review contained in its Final Report.

The Regional Review concluded with a fragile consensus regarding broad policy guidance on a number of issues related to the structure of the electricity markets and BPA's role in these markets. Its statement of broad policy is now subject to multiple interpretations and requires additional work toward real consensus.

The DSIs support the broad goals outlined in the Final Report taken as a whole. Some interests in the Northwest cite sections of the Final Report as if it were a precise blueprint -- etched in stone -- for the future of BPA and energy markets in the Pacific Northwest. We do not view the report in this light. The Regional Review Final Report provides broad policy guidance that point us in a direction, but the report is not comprehensive and it is not a blueprint for specific implementation.

The Steering Committee recognized the need for substantial work toward implementation, as evident in their recommendation to establish the Transition Board to oversee these implementation efforts and act as liaison with Congress on any legislative recommendations that could ensue.

There are many details and complicated issues that need to be addressed before implementation. Resolving these implementation details will likely stress the already fragile consensus on the broad recommendations. The potential for implementation having unintended consequences is high because the issues are complex and interrelated. No one will know until these details have been addressed what the impact will be on individual interests and the cumulative impact on the Northwest economy. Our effort, and we hope your effort, is to do everything possible to achieve a successful implementation of the Regional Review's policy objectives.

All parties are working hard and in good faith to reach consensus within the region on a set of proposals to implement the policy objectives of the Regional Review. To be successful, the proposals must be founded on a pragmatic assessment of commercial realities, and provide for meaningful and practical incentives for BPA to control its costs.

The recommendations of the Regional Review address transmission policies, Bonneville's power marketing policies, competition at the retail level and support for certain public purposes. I will specifically address the transmission and power marketing recommendations. Since retail competition and public purpose recommendations are matters before the state legislatures, I will not address those issues today.

Transmission

The Regional Review recommended legal separation of BPA's transmission and generation systems, and the formation of an independent grid operator to operate regional transmission and to be regulated by the Federal Energy Regulatory Commission (FERC). The broad policy objective underlying these recommendations is to create a transmission system whose structure and operation will ensure a fully competitive generation market. Separating BPA's control of transmission from generation is intended to prevent manipulation of access to transmission or the setting of transmission rates to advantage or subsidize the generation system.

Full legal separation and FERC regulation of BPA is a means to this end: transmission would be prevented from cross subsidizing BPA's generation and prevent other uses of the transmission system that would discriminate to advantage BPA generation. This is a goal the DSIs strongly support. However, full legal separation of BPA transmission is complex. If legal separation cannot be achieved without violating the underlying goal, full separation should be reevaluated.

Alternatives to full legal separation of BPA transmission may substantially achieve the policy objective and need to be explored. For example, legislation to subject BPA's transmission to FERC regulation identical to regulation of investor-owned utility transmission -- but without the added complexity of legal separation -- should be investigated. (In Order 888, FERC did not require full legal separation of IOU transmission.) In addition, we need to consider whether BPA, within current statutes, can operate the federal transmission system consistent with FERC Order 888, and if FERC can now adequately regulate BPA transmission without requiring legislation.

The DSIs are participating in a work group effort, under the auspices of the Transition Board, to explore alternatives such as these for the separation of BPA transmission. This effort should be concluded in the Fall, at which time the complex issue of legal separation should be better understood.

The Report also recommended the creation of an independent transmission system operator, regulated by FERC, which includes BPA's transmission assets as well as other transmission assets throughout the integrated system. Midway through the Regional Review, several investor-owned utilities announced their intent to form an independent grid operator, called IndeGo. Over the past year, intensive efforts have been dedicated to developing IndeGo, including detailed study of pricing, governance and operational issues. The

DSIs have participated in the development of IndeGo, to the extent allowed for a nonparticipant. This study has revealed how complex and difficult it will be to achieve BPA participation in a regional IGO -- primarily because of cost shifting between different transmission systems and among customers. Given the disparate cost structures among various owners of transmission in the Northwest, BPA participation in a regional IGO involves merging its relatively low cost system with systems of substantially higher cost. Despite yeoman efforts by the IndeGo pricing committee, to this date they have been unable to develop a transmission pricing methodology that does not shift costs to users of the BPA system. The DSIs, as major BPA transmission customers, cannot support BPA joining IndeGo, if the consequence is a doubling -- or more -- of their transmission rates. The costs simply outweigh the benefits.

The DSIs continue to favor the formation of IndeGo, but do not support BPA joining IndeGo if the result is a significant increase or shift in transmission costs. A preferable outcome is the formation of IndeGo which would then operate in close coordination with the BPA system. If BPA's transmission system is adequately separated and regulated by FERC, this may be an acceptable outcome to all parties. An added benefit of this scenario -- essentially two IGOs in the Pacific Northwest -- would be that there would be some degree of competition between the two transmission operators. Such competition would be a healthy inducement for keeping transmission costs, terms and conditions reasonable for transmission users.

Subscription

In much of the country, structural changes in power markets have opened up previously monopolistic electric systems to competition. These structural changes have created a set of problems that are very different from the situation facing BPA. BPA has always faced competition because it has no allocated service territory and because its transmission system has always been an open-access system. The essential problem BPA must address is that it no longer enjoys a substantial price advantage over its competitors. This problem was addressed in the Regional Review by the proposal to develop subscriptions as a means for BPA to sell its power in the period post-2001, when a majority of its existing power sales contracts expire. The fundamental policy objective is for BPA to establish business relationships that allow for the sale of Federal power at rates that recover the generation costs. A successful subscription will better align the benefits and risks of access to Federal power, improve BPA's ability to repay Treasury, obviate any need to debate the issue of transition cost or stranded cost recovery, and preserve for the Pacific Northwest the benefits of the Columbia River hydroelectric power system. Achieving these goals will require BPA to find new ways to meet the evolving commercial needs of its customers and, in particular, to reduce the cumbersome process for doing business with BPA. It will also be essential that BPA control its costs so it can offer cost-based services at rates that are competitive with market alternatives.

Under the auspices of the Pacific Northwest Utilities Conference Committee (PNUCC), BPA, its customers and other interested parties have embarked on a collaborative effort to negotiate the terms for subscription of Federal power. As customers have worked with BPA on a business relationship post-2001, it has become increasingly apparent that the subscription process must be flexible to accommodate a wide variety of customers' interests and needs. BPA must not be insulated from the competitive price pressures that provide the best assurance that costs, and therefore rates, will remain reasonable over time. We are participating in the subscription process and remain hopeful that BPA and customers are moving toward a successful subscription that involves voluntary, arms-length commercially reasonable contracts to meet customers needs and cover BPA's costs.

Transition Costs

There are some in the Northwest that recommend that Congress impose some sort of "stranded-cost" recovery mechanism, either as a backstop in case the subscription process fails, or potentially as a means to compel customers to do business with BPA. Such recommendations are premature, and are contrary to the recommendations of the Regional Review. Adopting a cost recovery mechanism at this time would frustrate the purpose of the subscription effort which is to cover BPA's cost through contracts voluntarily negotiated with customers for the products and services BPA can produce. An orderly process would be to identify whether there is stranded cost first and, if there is, then to address it at that time.

BPA's costs through 2001 are covered by its current contracts. We understand that BPA is currently earning surplus revenues from power sales and expects to have $600 million, or more, in accumulated cash reserves at the end of the five-year rate period ending in 2001. By 2001, BPA has stated its intention to get its costs in line with foreseeable market conditions. We are concerned that implementing a fall-back cost recovery mechanism at this time would only serve to relieve BPA of the need and motivation to control its costs.

There is some potential that BPA may have cash flow problems in some years. Cash flow is a problem, but it is inherent in setting rates for fixed periods in advance of actual knowledge of costs and sales with which BPA has always had to deal. There are many mechanisms to bridge cash flow shortfalls that do not involve making open-ended commitments to pay whatever BPA's costs happen to be in any future year. BPA can use its cash reserves, arrange for short term credit, or defer expenditures, much in the way it always has. Simply giving BPA a new taxing mechanism to generate revenue will be a disincentive to controlling their costs and could substantially jeopardize a successful subscription process.

Process

As a final point, I would like to address the Committee's question about BPA's participation in the Transition Board's efforts, and raise a concern with the level of process generally. Since its inception, the Regional Review process has been an inclusive attempt to bring customers, BPA, the states and other interests together to devise a transition for BPA to a more competitive environment. The Transition Board was established to track the progress of BPA, customers and other interested parties in implementing the policy goals outlined in the Final Report, and as a conduit to communicate to Congress on any need for legislative action the region might identify. I believe that BPA, customers and other interests are working hard and in good faith with the Transition Board toward successful implementation of these policy goals.

Increasingly, however, the Transition Board appears to be attempting to set policy and procedures for BPA. Earlier I stated that BPA needs to find more efficient means to conduct its affairs and meet the commercial needs of customers. I am concerned that subjecting BPA's marketing and operational decision-making to multiple public processes under the umbrella of the Transition Board or the Northwest Power Planning Council could impede instead of help BPA's efforts to operate more efficiently in a competitive environment. BPA has the statutory responsibility to manage its power marketing activities and its practical authority to manage its affairs should not be unduly encumbered by multiple layers of political oversight.

The level of process in the Northwest is extreme. For example, one DSI member company believes that its individual share of the cost of participating in the regional processes necessary to do business with BPA totals over $500,000 per year, every year, in excess of the costs that it would incur if it eliminated BPA as a supplier. Not only does BPA need to control its costs, if BPA is to be competitive with other suppliers, the excessive processes associated with doing business with BPA need to be eliminated.

Conclusion

BPA and its customers are actively engaged in exploring new business and structural arrangements to carry out the broad policy goals of the Regional Review. The Transition Board is overseeing this effort. The process is on schedule to replace BPA's existing power sales contracts with new voluntarily negotiated contracts before they expire in 2001. It is incumbent upon all of us to give this process every possible chance to work. If the subscription process is a success then BPA's costs will be covered, the federal debt will be repaid and there will be an orderly transition to a competitive marketplace. Congress should not condone any so-called "transition cost" proposal that would vitiate BPA's incentive to control costs and deprive the Pacific Northwest of the benefits of competition.

Thank you for this opportunity to testify before you on this important matter.

###